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Removing the Shackles

Deferring Capital Gains Taxes on Asset Rollovers

Jack M. Mintz
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The Backgrounder in Brief

Deferring capital gains taxes has plenty of appeal for investors who want to roll over their assets into new investments to reap better returns — without a tax bill. But how to implement the policy? The authors provide a model, the Capital Gains Deferral Account (CGDA) that would benefit middle- to low-income investors most.

About the Authors

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In the 2006 federal election, the Conservatives proposed that capital gains taxes be deferred when people roll over their assets to rebalance their investment portfolios or substitute one real estate asset for another. It was far from clear, however, how this rollover would be implemented, thereby leading to many questions being asked regarding its details (see Kesselman 2006 and Mintz 2006).

The intent of this Backgrounder is to outline a specific approach to implementing a deferral of capital gains taxes. It would apply when investors rebalance their portfolios by selling poor-performing assets to purchase those with better expected returns and only include assets that are not part of pension and Registered Retirement Savings Plan (RRSP) accounts. When investors hold some assets for longer periods to avoid triggering capital gains taxes, capital market efficiency is impaired since businesses are given the wrong signals about the quality from markets. Hence, allowing investors to buy and sell assets, while deferring taxes on their capital gains makes sense.[1] However, formulating the actual details to achieve this objective requires some artwork by tax policy designers. We believe our proposal can be implemented to improve the efficiency and the fairness of the tax system.

We begin our discussion with an analysis as to why permitting some deferral of capital gains taxes on asset rollovers is appropriate. We then turn to specifics of the proposal, followed by an analysis of the incidence and revenue cost.

Capital Gains Taxes: Tax Policy Objectives

Capital gains taxation is the most problematic and controversial part of tax systems worldwide. As seen in Tables 1 and 2 for G-7 countries, a wide variety of approaches are used to reduce capital gains taxes. Some countries like the UK and the US provide a limited rollover and all, including Canada, allow for the deferral of capital gains taxes when companies are reorganized through acquisitions, mergers and windups. Some levy tax on capital gains at death while others may exempt such gains (with estate taxes being imposed instead).

Some argue that capital gains should be fully taxed like other income without special relief. When a government taxes income on a comprehensive basis, capital gains and losses on the selling of assets should be taxed on an accrual basis; that is, taxes should be imposed on net increases in the value of assets held by taxpayers (even though the assets are not disposed of). Just as in the case of dividend income, we should recognize that capital gains on stocks reflect business taxation that reduce the gains received. By setting 1/ the capital gains tax rate equal to the dividend tax rate; and 2/ the combined corporate and personal rate on dividends and capital gains to be the same as tax rates on other sources of

We wish to thank Yvan Guillemette and Finn Poschmann for their assistance with compilations. We also want to thank Earl Bederman of Investor Economics, Joanne DeLaurentiis of the Investment Funds Institute of Canada and Pierre Leblanc of Finance Canada for assisting with data. Comments from Jamie Golombek, Yvan Guillemette, Finn Poschmann and Bill Robson are gratefully acknowledged.

1 Various studies have shown that capital gains realizations are sensitive to tax cuts (Zodrow 1995 and Klein 2004) and cuts to capital gains taxes in Canada have a significant and positive impact on realizations (Mintz and Wilson 1995).

Table 1: *Tax Treatment of Stock Capital Gains under Personal Income Tax for G-7 Countries*

	Special Relief
Canada	Half-inclusion in income and $500,000 lifetime exemption for the sale of shares held in CCPCs. Rollover also provided for replacing assets sold in qualifying CCPC shares.
France	27 percent on gains in excess of E15000.
Germany	Gains exempt on shares if ownership is less than 1 percent and shares held at least one year. Otherwise, half exempt but fully taxed for shares held for less than one year
Italy	Gains are taxed at 12.5 percent for ownership less than the minimum. Two-fifths of capital gains are taxed when shares owned are more than 2 percent of public companies or 20 percent of private companies. Cost basis is indexed for inflation.
Japan	Gains taxed at 20 percent although gains from listed shares taxed at half the rate until 2008.
United Kingdom	Net capital gains taxed at normal rates. Taper relief is provided whereby 5 percent of gains on non-business shares are excluded for each year that assets are held beyond two years up to a maximum exemption of 40 percent of the gain after 10 years of ownership. For business assets, taper relief begins after one year, after which 50 percent of gains is excluded followed by 75 percent exclusion after second year. Deferral is provided for business assets if proceeds are reinvested in new assets. First L8200 of capital gains is exempt.
United States	Gains on shares held for more than one year taxed at a federal rate of 15 percent (state rates vary). Short-term gains taxed at full rates. Investors holding qualified small business stock for more than five years are taxed on half the gain.

Source: Ernst &Young, *The Global Executive*, EYGM, 2005.

Table 2: *Tax Treatment of Real Estate Capital Gains under Personal Income Tax for G-7 Countries*

	Special Relief
Canada	Half-inclusion in income but principal residence exempt and $500,000 of lifetime gains from the sale of farm property. Rollover of capital gains on business properties if reinvested in equivalent properties.
France	27 percent on gains in excess of purchase and repair costs, reduced by one-tenth each year after 5 years held. Principal residence exempt.
Germany	Gains fully taxed if real estate held for less than 10 years unless property used by taxpayer for three years.
Italy	Gains taxed if property held for less than five years and is not a principal residence.
Japan	Gains from property held more than five years taxed at 26 percent. For other gains, 40 percent is subject to normal income tax rate plus 12 percent inhabitant tax. Gains from residential property are taxed at 14 percent on gains up to Y60 million and 20 percent in excess (if property is held more than 10 years).
United Kingdom	Similar treatment to securities. Principal residence is exempt from capital gains tax.
United States	Real estate gains are subject to tax although the tax can be deferred if proceeds are reinvested in new real estate. Gains from selling a principal residence in excess of $250,000 ($500,000 for joint filers) are exempt when property is lived in for two of five years.

Source: Ernst &Young, *The Global Executive*, EYGM, 2005.

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income, the same amount of tax is paid regardless of the organizational and financing decisions of businesses.

Outside of financial traders,[2] no country in the world applies capital gains taxes on an accrual basis for portfolio investors since it is virtually impossible to do so simply. Some assets are not actively traded so that their market values are not readily determined (such as real estate and private company shares). Further, taxing capital gains on an accrual basis would force some taxpayers, such as farmers and small business owners, to liquidate assets in order to cover capital gains taxes. Thus, countries generally tax capital gains when assets are disposed of and capital gains realized.

Taxing capital gains realizations rather than accruals, however, creates a major tax policy dilemma. Even though taxes should apply broadly to economic income including capital gains, taxes levied on realizations discourage investors from "unlocking" their gains. This could result in savers holding some assets with inferior financial performance in order to avoid triggering capital gains tax upon their disposal. Further, as capital gains that arise from general inflation are taxed (as is the inflation component of investment income) marginal effective tax rates are increased as a result. Finally, in order to minimize opportunities for investors to avoid tax by selling off securities with built-up capital losses, these losses can only be applied against capital gains on asset sales.

On the other hand, reducing the effective tax rate on capital gains relative to other sources of income encourages businesses and investors to strip out corporate income in the form of capital gains (this is referred to as "surplus stripping"). Low capital gains taxes encourage investors to buy companies that reinvest their profits rather than pay out distributions (which in part has led to the growth of income trusts as a counter-balance to this favourable treatment). Care thus has to be taken to ensure that capital gains taxes are not altogether avoided when other income is more heavily taxed.

It is therefore difficult to get the right balance for the taxation of capital gains, especially given the economic problems arising from the "lock-in" effect. Canada, like many countries, already provides a rollover treatment for some assets that allow investors to defer capital gains to later years. Investors can avoid the immediate payment of capital gains taxes on share-for-share exchanges or the disposal of assets when companies are acquired, amalgamated or wound-up. Limited deferrals are also provided for the sale of real properties when replaced in businesses. In 2002, the Liberal government introduced a provision to allow entrepreneurs to defer capital gains taxes on the sale of shares of a matured Canadian-Controlled Private Corporation if the investment is replaced by an investment in a new eligible business.

Seen in this light, the Conservative proposal to allow investors to roll over assets to defer capital gains taxes would reduce the degree to which the "lock-in" effect would discourage investors from rebalancing their portfolios to maximize

2 Financial traders are subject to full taxation of investment income and capital gains as business income. Capital gains are subject to mark-to-market rules whereby the change in the market value of a trader's portfolio of marketable securities is taxed even if the assets are not disposed.

their financial returns. Below, we outline a detailed proposal to extend rollover provisions in the tax system.

Principles for Design

In designing a rollover proposal, three principles are borne in mind.

- The rollover should reduce the impact of the "lock-in" effect on investors who should be rebalancing their portfolio of securities to improve their returns on investments. This allows them to accumulate wealth more quickly to finance their retirement needs and other contingencies.
- The proposal should benefit investors who need better investment performance to fund future contingencies, including their retirement.
- The system should be kept as fair and simple as possible.

Given these principles, relief should be directed at individuals,[3] not corporations who already avail themselves of provisions that provide capital gains tax deferrals for corporate reorganizations.[4] Capital gains taxes on deemed realizations at death should continue to be applied to ensure that a taxpayer cannot escape capital gains taxes altogether. Further, capital gains taxes should be collected on Canadian taxable property sold by non-residents or migrating Canadians.

The choice of the ultimate design of the capital gains rollover will depend on the revenue loss incurred. Below, our proposal is designed so that its application will depend on the revenue loss tolerated by the government.

Possible Approaches to a Tax-Free Rollover

One approach we considered to permit the deferral of capital gains is based on a recommendation made by the Technical Committee on Business Taxation regarding an enhanced Registered Retirement Savings Plan (RRSP) for small business and farmers.[5] As a version of the Committee's proposal, taxpayers could make a tax-free transfer of capital gain realizations from the disposal of eligible assets to RRSPs. Within the RRSPs, assets can be rolled over without payment of tax until the money is withdrawn from accounts. To provide greater relief, RRSP contribution limits would need to be increased to accommodate the transfer of capital gains to the accounts. The tax system could be further simplified by

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3 Included would be capital gains earned by mutual fund corporations, which are important portfolio investments for individuals.

4 One restriction that has affected companies is that deferral is only provided to investors when corporate reorganizations take place between companies that are both resident in Canada. The Department of Finance has indicated that they would consider measures to provide deferral for corporate reorganizations involving a Canadian and non-resident company, perhaps on a treaty basis. We would argue that cross-border transactions should be eligible under certain circumstances for rollover provisions as they affect corporate reorganizations.

5 We are especially indebted to Finn Poschmann who suggested a scheme similar to the one we now describe.

replacing the $500,000 lifetime capital gains exemption for owners of shares in Canadian-controlled Private Corporations and farm property.

This approach to the rollover has much to commend about it since it is relatively simple to apply using the current framework for the RRSP system. It also would allow investors to defer taxes on dividends and other income earned from the invested capital gains until withdrawn from the RRSPs. However, we have two concerns with respect to its application. The first is that the limit on total capital gains eligible for a transfer penalizes the more successful investors who accumulate capital gains faster because of better decisions. Our preference is to impose limits, when needed, on the total contribution of savings to the portfolio eligible for the rollover rather than set limits on capital gains. Second, making enhanced contribution room available only to owners of eligible assets with capital gain realizations gives rise to the natural question: why not give the same relief for other income, like dividends and interest, earned from other investments to provide retirement income.

Another alternative to deferring capital gains taxes is to exempt them altogether. This can be limited to a certain amount of assets invested in a plan that could be rolled over without the gains being taxed (other income would continue to be taxed). The argument in favour of full exemption is that taxes levied on the return to savings reduce the amounts of income available for future consumption needs. Savers are more highly taxed than consumers when investment income and capital gains on saved earnings are taxable. Unlike consumers who pay income tax only on earnings that are consumed, savers must also pay tax on the income earned from their invested earnings. While this approach would certainly be appropriate to consider, it would be hard to justify the exemption of capital gains when investment income from other sources remains subject to tax. For this reason, we would prefer Tax-Prepaid Savings Plans that would exempt both investment income and capital gains from tax altogether (Kesselman and Poschmann 2001).

The Capital Gains Deferral Account

We propose the introduction of a Capital Gains Deferral Account (CGDA), which would allow individuals to roll over investment securities within the account without having to pay capital gains taxes until assets are withdrawn from the account. When funds are withdrawn from the plan, capital gains taxes would apply on a pro rata basis: for example, a withdrawal of 10 percent of the current value of the plan would be treated as a withdrawal of 10 percent of the original cost base, and 10 percent of the accumulated net capital gain. To calculate the capital gains tax, the original cost base of the aggregate contributions of capital (including reinvestment of dividends and interest within the plan) needs to be determined. The difference between the total value of assets in the plan and the original cost base is the accumulated net capital gain.

Conceptually, the CGDA is similar to the Indexed Security Investment Plan[6] introduced in the early 1980s that indexed capital values for inflation when

6 Indeed, some of the detailed provisions of these plans can be used to draft legislation.

Table 3: *Taxable Capital Gains by Total Income Class, 2003 Tax Year*

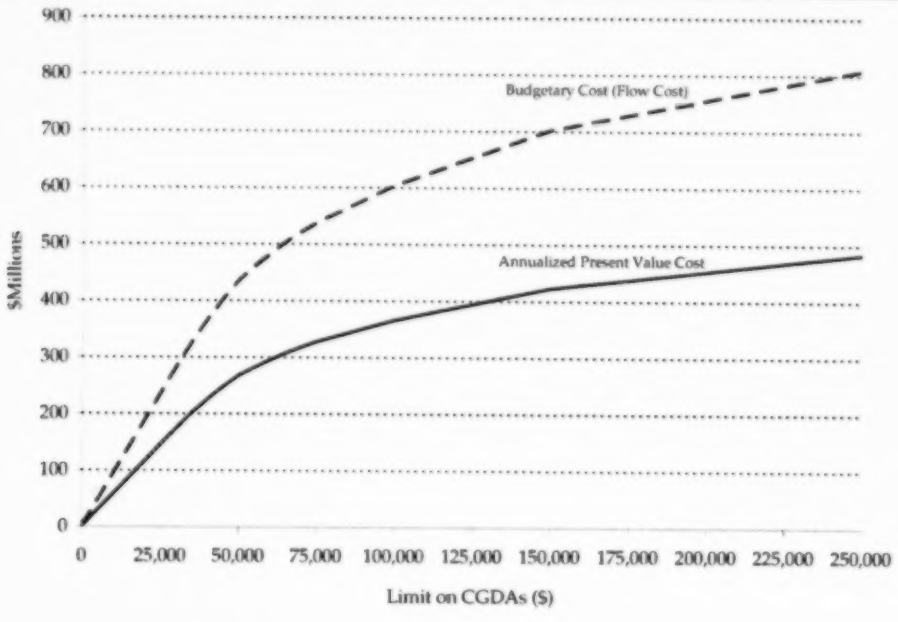
Total Income Class	Number of Taxable Returns in Income Class	Number of Returns with Taxable Capital Gains	Average Taxable Capital Gains per Return ($)	Average Taxable Capital Gains per Return with Taxable Capital Gains ,$)
$0 and below	880	50	42,463	747,340
$1 - $10,000	524,210	16,320	45	1,459
$10,000 - $15,000	1,227,140	37,070	51	1,689
$15,000 - $20,000	1,771,330	66,310	70	1,874
$20,000 - $25,000	1,650,970	72,440	85	1,937
$25,000 - $30,000	1,563,270	76,030	102	2,091
$30,000 - $35,000	1,517,100	76,490	129	2,565
$35,000 - $40,000	1,308,080	75,720	169	2,913
$40,000 - $45,000	1,103,440	70,480	195	3,051
$45,000 - $50,000	908,040	59,830	208	3,150
$50,000 - $60,000	1,359,100	102,820	271	3,581
$60,000 - $70,000	929,290	83,360	373	4,161
$70,000 - $80,000	627,080	65,920	534	5,078
$80,000 - $90,000	372,390	47,760	818	6,379
$90,000 - $100,000	240,210	37,060	1,183	7,671
$100,000 - $150,000	444,440	85,530	2,333	12,122
$150,000 - $250,000	179,030	49,860	6,895	24,759
$250,000 and over	110,110	41,680	35,689	94,282
All/average	15,836,110	1,064,730	581	8,648

Source: Canada Revenue Agency

assessing capital gains taxes. Under that plan, three-quarters of capital gain taxes in a year could be deferred until an asset was taken out of the plan (the other quarter would be taxed on an accrual basis). Our proposal would effectively drop the indexation provision and eliminate the requirement for some capital gains to be taxed on an accrual basis.

To limit the proposal for revenue reasons and to provide greater benefit to smaller investors, we recommend that a lifetime limit, to be discussed below, be placed on the amounts to which investors may contribute to the CGDA. As noted earlier, we do not believe that the limit should be based on lifetime capital gains since it would penalize investors who choose better portfolios — the aim of the program is encourage capital to flow to better performing assets. An annual limit could also be imposed, increasing with age of the investor, although in that case we recommend that any unused annual contribution room could be carried forward. Any assets moved into the plan could be subject to deemed realization of capital gains and losses at the time of transfer if the government wishes to provide the benefit on a go-forward basis rather than provide windfall benefits to past investments. Alternatively, the relief could be given on past deferred capital gains if placed in the account if the intent is to unlock existing gains. If the existing deferred capital gains were eligible for the GGDA, the initial revenue cost of the proposal would be substantially larger.

Figure 1: *Revenue Loss With Different CGDA Contribution Limits*



Income earned within the CGDA (dividends, rents and interest) would be taxable and eligible for credits in the year it is incurred. If this income is left inside the CGDA, it will be added to the original cost base of the assets. Eligible assets in the CGDA would be broadly allowed to permit investors to maximize gains from their portfolios. The qualifying assets would be those eligible for RRSPs, including domestic and foreign equity securities, income trust units, marketable bonds and money market instruments. Assets not eligible for the CGDA would include principal residences, other real estate, personal use properties, cottages and consumer durables. Investors borrowing money to finance investments in the CGDA would be allowed to deduct the interest expense against investment income and capital gains upon disposal when taxable.

By limiting the amounts eligible for the CGDA, the benefit provides greater assistance to smaller investors. In Table 3, we provide the number of taxable returns and per return capital gains reported for different income classes for 2003/04, showing that a large number of taxpayers earn some capital gains in lower- and middle-income groups. Almost three-quarters of returns reporting capital gain income are from taxpayers with less than $70,000 in taxable income. They report modest amounts of capital gains that are less than $5000 per return. Thus, the CGDA would benefit more low- and middle-income Canadians with some capital gain income.

The "mature system" flow cost and annualized revenue cost is estimated in Figure 1, using different possible limits.[7] The flow cost is the loss in current tax

7 The federal and provincial revenue loss is calculated by assessing the impact of the limit on different income groups and applying existing tax rates to 2003 capital gains (the most recent data) earned by each income class (only those returns reporting capital gains are included). Assuming that investors take full advantage of the account, we estimate the revenue loss from ...

revenue without taking into account that the gains would be eventually subject to tax. The annualized cost is the flow cost net of the future taxes paid on gains when assets are taken out of the account. A portfolio lifetime limit of $150,000 in contributions to the plan, which would defer most taxes on capital gains for lower income investors when rebalancing their portfolios, would have an annual flow cost of over $700 million and an annualized cost of $425 million in federal and provincial taxes, taking into account the shift of taxes paid from present to future periods when assets are cashed out. A limit of $50,000 on a lifetime basis would result in annualized revenue cost of about $250 million. Thus, the size of the limit will determine the degree to which the government incurs revenue loss.

Conclusions

The Conservative proposal to provide an opportunity for Canadians to rebalance their portfolios to avoid payment of capital gains taxes at time of disposal has some merit. It would allow taxpayers to shift their portfolios from poorer to better performing assets, an important signal to businesses looking to raise capital from markets. We suggest legislation that would introduce the CGDA account. It would have a lifetime contribution limit of $150,000 and allow investors to defer tax until the accumulated wealth is withdrawn from the account. The benefits would primarily be aimed at low- and middle-income Canadians who have modest amounts of taxable capital gains. The annualized revenue cost to federal and provincial governments is estimated to be about $425 million for a lifetime limit of $150,000, although the cost could vary depending on the chosen limits.

Footnote 7 continued.

... deferring capital gains by assuming that assets are rolled over every five years (these data were provided by some financial institutions to us). We assume that assets are kept in the account for 20 years on average, taking into account the distribution of investors according to age (data provided by Investor Economics). Taking a 20-year average increase in TSE stock exchange index (6.29 percent), we compare the tax paid by investors if they hold assets outside of the CGDA with taxes paid if assets are held for 20 years within the CGDA. The present value of taxes paid is compared and the revenue loss on an annual basis is calculated as flow cost. Amounts were further reduced for those capital gains reflecting deemed realizations at death and non-resident ownership of Canadian taxable property (such gains are included in the statistics and were provided by Finance Canada). The discount rate used for the assessment is 5 percent per year, based on government bond yields.

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